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## Corporate Governance and Firm Performance of Listed Firms in Sri Lanka

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### Abstract

The aim of this study is to examine the relationship between corporate governance structures and firm performance of listed firms on Colombo Stock Exchange (CSE) in Sri Lanka. Data were collected from 174 firms in the financial year 2010 and multiple regression analysis were used to examine whether the existing corporate governance mechanisms influence the firm performance of listed firms in Sri Lanka. The study found evidence that, (i) board size and proportion of non- executive directors in the board shows a marginal negative relationship with firm value, (ii) proportion of non-executive directors in a board and financial performance of firm shows negative relation contrary to the findings of previous studies. The firm size and director shareholdings have a significant impact on firm performance of listed firms in Sri Lanka.

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**Key words:** Corporate governance, Performance, Non executive directors, CEO duality

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### 1 Introduction

The concerns and discussions on corporate governance has been a popular issue in developed countries and widely researched. These discussions date back to early 1930s since the theory of separation of ownership and control [1]. However, corporate governance was triggered in developing countries such as Sri Lanka with the recent corporate collapses. The need for effective corporate governance is evidenced and reactionary governance reforms have been instigated to prevent such events happening again to protect the interest of investors in developing countries.

In the Sri Lankan context, the issue pertaining to corporate governance had been increasingly spoken of in the recent past and the revised and expanded Code of Best Practice (CBP) on corporate governance was introduced in 2008. Despite significant efforts to put regulatory frame work for corporate

governance in Sri Lanka, studies on corporate governance practices at the firm level and their effects on firm performance is largely lacking.

## **2 Objective of the study**

The objective of the study was to examine whether the existing corporate governance mechanisms influence the firm performance in Sri Lanka. This study is also notable in a number of ways; firstly, the study will contribute to the existing body of knowledge concerning corporate governance practices on firm performance of listed firms in Sri Lanka. Secondly, the outcome of this study will help interested parties to know the level of compliance of recommendations made in the CBP.

## **3 Literature review**

There are contrasting findings that suggest that there may be positive and negative relationship between board size and firm performance. It is evident that the large boards are less effective than small boards [2, 3]. Contrasting to above it was concluded that the larger board is good for a firm [4].

With respect to the board composition, it is found that an increase in the percentage of outside directors can improve firm performance [5, 6, 7, 8]. However, number of studies suggested a negative relationship between board independence and firm performance [9, 10].

The chairman's role should be separated from that of CEO [11]. Empirically it was concluded that firms are more valuable when the CEO and board chairman are separated [3, 12]. However, the firm performance improved by combining those roles rather than separating them [13, 14].

There are numerous studies that examine the relationship between insider ownership and firm performance. It was evident that insider equity ownership correlates with improved performance [15, 16]. In contrast, it was found that there is no significant relationship existing between ownership and performance.

In view of the continuing debate surrounding corporate governance mechanism and its relationship with firm performance is still an unresolved.

## **4 Sample and data**

As at the end of year 2010, there were 243 firms listed on the CSE. Due to different statutory requirements, all firms of Bank, Finance and Insurance sector were excluded and 17 other firms were also excluded because of difficulties in obtaining the relevant data from the population. Since, the final sample was 174 listed firms, relevant data related to corporate governance variables and performance measurements were gathered for the year 2010 from the website of the CSE.

Independent variables which were considered are board size (BSIZE), proportion of non executive directors in a board (NED), director's shareholdings (DHOLD) and CEO duality (CEODUA). The Return on Assets (ROA) and Tobin's Q were used as performance measurements and firm size (SIZE) measured by turnover was used as the control variable in this study.

## 5 Results and discussion

The table 01 summarized the descriptive statistics for the variables employed in the study.

Variables	N	Mean	Max	Min	SD
Board Size(BSIZE)	174	7.78	14	3	2.125
Number of NED	174	5.30	12	0	2.533
Directors Share Holding(DHOL)	174	7.70	70.34	-	16.104
CEO Duality(CEODU)	174	0.12	1	0	0.3299
Total Turnover-Rs.'000(SIZE)	174	3234986	63523824	969	9449585
Return on Assets (ROA)	174	0.08	0.58	-0.22	0.112
Tobin's Q	174	1.27	4.12	0.54	1.082

**Table 01:** Descriptive Statistics for the year 2010

The table 01 shows that the average board size of 7.78 directors per board with a standard deviation of 2.1 with regard to all the 174 firms observed and has a wide range from 3 to 14. This is in far with many studies undertaken previously in developed countries. This table also shows that the number of non-executive directors per board was 5.3 with a standard deviation of 2.5 and have a range from 0 – 12. This is fair with compare to the developed markets.

The results of the multiple regression analysis were presented in the table 02.

Panel A: Regression summary of dependent variable ROA and Tobin's Q								
Variable	Coef.	ROA			Coef.	Tobin's Q		
		St. Err of Beta	t	P value		St. Err of Beta	t	P value
Intercep			1.34612	0.16138			-0.04702	0.97433
BSIZE	-0.05791	0.07216	-0.82728	0.40937	-0.03379	0.06347	-0.53235	0.64237
NED	-0.08978	0.07394	-1.21419	0.17456	-0.00493	0.06382	-0.07725	0.94373
DHOLD	0.00611	0.08576	0.07125	0.94480	<b>-0.12936</b>	0.07564	-1.71021	0.07945
CEODU	0.03124	0.07521	0.41535	0.68713	0.002978	0.06173	0.04824	0.97423
SIZE	<b>0.28792</b>	0.07248	3.97296	0.00006	-0.00081	0.06311	-0.01283	0.99148
R <sup>2</sup>	0.09301				0.35642			
N	174				174			

**Table 02:** The relationship between measures of performance and governance structures

The Panel A of the table 02 indicates that only the size of the firm has a significant impact on ROA. It says that larger the size of the firm, ROA will also be higher and vice a versa. Beta coefficient for firm size stood at 0.28792 while p-value was 0.0000627. All the other independent variables found to be less impact in determining ROA. However, the low explanatory power of the model ( $R^2 = 0.093$ ) says that model cannot be relied upon as a good way of explaining the impact.

Relative to the regression run for ROA, model for Tobin's Q results an  $R^2$  of 0.36. This indicating that the independent variable explains about 36% of the value of Tobin's Q. This is fairly a good model and it was found that there was a significant negative impact of directors shareholding on the value of Tobin's Q and p-value was almost zero at 95% confidence limit. Beta coefficient was -0.12936 and it implies that the value of firm is negatively related with the proportion of the director's shareholding of the firm.

Nevertheless, none of the other variables shows a significant impact on ROA or Tobin's Q.

## 6 Conclusion:

The objective of the study was to examine whether the existing corporate governance mechanisms influence the firm performance in Sri Lanka. Conclusive notes drawn on the findings of data analysis could be summarized as follows.

A negative correlation between the proportion of non-executive directors and ROA was found to be non significant but it contrary to other findings, indicated a positive relation. No significant correlation was found between separation of office of CEO from chairman and performance.

The relationship between board size and Tobin's Q and proportion of non-executive directors and Tobin's Q were marginally negative, but the results were not statistically significant. Neither the directors' shareholding nor the separation chairman's role from CEO had any significant impact on firm value. Hence, it could be noted that all the recommendations made in CBP with regard to the composition of board has a negative impact on the value of firm measured by Tobin's Q.

The results presented in this study were restricted by less number of variables related corporate governance and data pertaining to year 2010 were addressed, which limits the generalization of the findings, therefore, it is suggested that future research should be carried out with a large number of governance variables and data pertaining at least to three years.

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